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Conduent, Inc. (CNDT)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Conduent Fourth Quarter and Full-Year 2018 Earnings Conference Call.

All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. In the interest of time, we ask that you please limit yourself to one question with one follow-up. Please also note today's event is being recorded.

I would now like to turn the conference over to Alan Katz, Vice President of Investor Relations. Please go ahead.

Alan Katz

Vice President-Investor Relations, Conduent, Inc.

Good morning, ladies and gentlemen, and welcome to Conduent's fourth quarter and full-year 2018 earnings call.

Joining me on today's call is Ashok Vemuri, Conduent's CEO; and Brian Walsh, Conduent's CFO.

Following our prepared remarks, we will take your questions. This call is also being webcast. A copy of the slides used during this call was filed with the SEC this morning. Those slides, as well as a detailed financial metric sheet are available for download on the Investor Relations section of the Conduent website. We will also post a transcript later this week.

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During this call, Conduent executives may make comments that contain certain forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995 that, by their nature, address matters that are in the future and are uncertain. These statements reflect management's current beliefs, assumption and expectations as of today, February 20, 2019, and are subject to a number of factors that may cause actual results to differ materially from those statements.

Information concerning these factors is included in Conduent's Annual Report on Form 10-K filed with the SEC. We do not intend to update these forward-looking statements as a result of new information or future events or developments except as required by law. The information presented today includes non-GAAP financial measures. Because these measures are not calculated in accordance with U.S. GAAP, they should be viewed in addition to and not as a substitute for the company's reported financial results prepared in accordance with U.S. GAAP. For more information regarding definitions of our non-GAAP measures and how we use them, as well as limitations as to their usefulness for comparative purposes, please see our press release, which was issued this morning and was furnished to the SEC on Form 8-K.

With that, I will turn the call over to Ashok for his prepared remarks. Ashok?

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

Good morning, everyone, and thank you for joining our 2018 fourth quarter and year-end earnings call. Brian and I will cover our Q4 2018 and full-year 2018 financial and operational performance highlights, outline select client wins that demonstrate the robustness of our core digital interactions offering and, lastly, our outlook for 2019. We will then take your questions.

I'll start with an overview of key highlights for the quarter and the full-year on slide 3. 2018 was an important year in Conduent's journey. This was the end of the second year of Conduent as a standalone company, and we accomplished several noteworthy milestones that I would like to very quickly recap. I will then focus my remarks on our pivot to growth. We successfully concluded the three-year cost transformation program that began in mid-2016 over achieving our targeted savings of $700 million by approximately $30 million. My management team and Conduent teammates worldwide did an exemplary job in helping the company improve its financial health. Brian will take you through more specifics on this.

We ended 2018 with a meaningfully stronger balance sheet, healthier cash position and a significantly lower net leverage ratio at 1.2 turns. We concluded our divestiture program with the closure of the sale of a select portfolio of standalone customer care contract in January 2019. In total, in 2018, we divested approximately $1 billion of revenue that was either non-core, unprofitable, not positioned for long-term growth or had no current scalable technology underpinning it.

We now have a clean, robust core business with a marquee set of clients, tenured relationships and differentiated set of key digital offering. We have consolidated our technology assets into 81 technology platforms across 24 business solution areas.

Many of them have been modernized while some are being rapidly modernized and/or upgraded. We continue to win industry recognition for the breadth and depth of our capabilities across diverse end-markets covering commercial, transportation and government sectors.

We are pivoting to and investing in our digital interactions offerings. This is our go-to-market strategy, reflecting our ability to provide mission-critical transactions to secure scalable technology platform, leveraging our expertise

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across process, domain and technology. This approach is gaining a lot of traction and our clients appreciate the new digital paradigm that we bring to bear, interactions that are individualized, immediate and intelligent.

As previously discussed, we anticipate investing a total of approximately $200 million by 2020 in the comprehensive enhancement and upgrade of technology assets, both client-facing platforms and applications, as well as infrastructure.

Though much has been accomplished and we are seeing benefits of improved technology in signing, pricing and better client delivery, progress continues unabated, and this remains a top priority for 2019. Specifically, in terms of our progress on IT infrastructure, modernization, simplification and data center consolidation, the key focus point for us in 2018 and will remain so in 2019.

We continue to dedicate the necessary resources to build a best-in-class infrastructure to run our leading-edge client applications. Across the organization, we have rationalized, optimized and standardized our assets including our workforce, digital processes and technology platforms. This critical body of work executed in a mere two years has laid a strong foundation for our pivot to growth.

Now, let me discuss our pivot to growth. Our core business is stable. Adjusted revenue normalized for divestitures and the strategic action was flat for the full year, with several of our large and higher margin offerings showing growth. Our free cash flow has dramatically improved over the past 24 months. We have gone from a user of cash in 2016 to generating more than $200 million in free cash flow in each of the past two years.

At $12 billion, our pipeline is healthy and has remained stable over the past year. Actions we took were verticalization of the go-to-market, hiring new talent, realignment of our sales compensation model, changing our mix of hunters versus farmers, and building traction for our digital solutions among others. This has had a positive effect on both the quality and the quantity of the pipeline.

Our pipeline also reflects the benefits of increased sales discipline, as well as investments in sales force capability, reflecting in better deal and contract terms, as well as pricing, margins and renewals.

Progress on the new business front is encouraging. We achieved new business signings growth of 6% in fourth quarter on a year-over-year basis. Increasingly, our deal wins are centered on supporting our clients' digital journey, leveraging our differentiated technology platforms and end-to-end digital solutions. And we continue to make prudent investments in our sales capabilities.

We are amplifying organic growth with strategic inorganic M&A. To that end, we closed on the acquisition of Health Solutions Plus, which is already bearing fruit in terms of both market-leading technology and exciting new business opportunities across both our commercial and government healthcare segments.

We have a growing, strategic and diverse base of ecosystem partners, including technology companies, cloud partners and universities. With technology and innovation as the backbone of our value proposition, we work with our partners to co-innovate solutions that will enable competitive differentiation, particularly in the areas of blockchain, automation, cognitive analytics, mobility, IoT and digital experience.

We are moving up the value chain, and the nature of client conversations has changed over the past year. Today, our conversations are centered around how Conduent can help transform their business and operating models to effectively compete in a rapidly changing integrated digital ecosystem.

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The focus is clearly shifting to outcomes and experiences, versus traditional service metric. To this end, our suite of offerings today is built around delivering best-of-breed experience outcomes. We leverage our domain expertise, process know-how and the consultative and advisory skills of our talent base to deliver scalable and secured digital interactions across every touch point in our clients' digital value chain.

For example, at one of our top and longstanding pharma client, we are now deploying an innovative patient engagement platform that is enabling patient intimacy and transparency in operations; and the ability to monitor engagements across three suppliers of top selling medication.

As we focus on the end-user experience, we will be implementing our Conduent automation suite, which uses bots to automate workflows, resulting in additional efficiencies and a significantly enhanced patient experience. Another example is at a leading global automotive manufacturing company; Conduent's relationship has evolved from providing transactional support in the areas of finance, accounting and procurement, measured through traditional affiliates to becoming a transformational business partner.

We are developing an integrated end-to-end source-to-pay process vision and road map, supported by new technology platforms, analytics, robotic process automation and machine learning that will enable desired business outcomes for our clients, including cost reduction, cash flow optimization, revenue leakage prevention and improved supplier relationships.

I'm also pleased to share that we are seeing early improvement in our Europe business, resulting from a reorganization and greater sales focus directed across key segments and services in the European market. With the divestiture of our select portfolio of customer care contract, our Europe sales team is now focused squarely on higher value-added services and increased service line penetration. The results of this shift are encouraging. In Q4, our non-customer care Europe pipeline increased by more than 20% over the previous quarter and our technology solutions are gaining traction with clients.

As an example, in Q4, we closed an opportunity with a leading European global professional services organization where we will provide end-to-end HR services. We are elevating the employee experience for this client by using a digital workforce model that leverages people and automation to improve the entire employee lifecycle journey, from recruit to retire. This next-generation technology simplifies complex HR business processes by providing convenient portals that allow employees to access a myriad of self-service tools and platforms.

The confluence of pipeline momentum, technology-based offering evolution and an optimized asset base, gives me confidence that we have the right ingredients to achieve sustainable and profitable growth. Our efforts of the last couple of years have positioned us well to realize continued progress in 2019. At the midpoint of our guidance ranges, we expect to grow revenue by 1% and expand adjusted EBITDA margins by 130 basis points over 2018 without any incremental M&A activity.

Before I segue into the next section, I want to share another important update. I'm happy to report that we have recently come to an agreement with the State of Texas regarding the long-standing litigation matter. With this settlement, we can put this legacy issue and the uncertain financial exposure that it's created behind us. This issue has consumed a tremendous amount of management time, and I'd like to thank everyone who's helped us resolved this. Texas remains an important client for us, and we are focused on continuing to bring value to our client and its citizens.

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Let me now spend some time going over the details of why I am confident that we can achieve our 2019 and longer term goals. I'm on slide 4. As I mentioned in my opening remarks, slide 4 provides a unique and fairly comprehensive overview of the transformation achieved till date.

Let's discuss the facets of change and what we have focused on that has led to the success of our transformation program. In terms of clients, strategic management of our client portfolio has been a key focus for us. We exited 10,000 accounts, including divested businesses, that were not aligned to our long-term business model. We've also built out the appropriate pipeline of new potential clients through the realignment of our go-to-market teams and are focused on selling under the rights offering architecture.

In 2018, we covered meaningful ground toward streamlining our legacy IT infrastructure while making the investments necessary to improve our IT performance. This included efforts on data center consolidation, take back of outsourced software development and maintenance, vendor consolidation, rationalizing and renegotiating service-level agreements, et cetera.

We achieved CMMI Maturity Level 3 certification, a huge improvement over our legacy and one which reinforces Conduent as a reliable, best practices technology-led company that consistently delivers quality software on time and within budget. This is an important step towards improving predictability of IT delivery for our customers.

Lastly, we are working with top-tier partners and experts to remediate the issues I spoke about during the last earnings call. We are starting 2019 from a stronger infrastructure foundation, so this will remain a work in progress in 2019. At the same time, the progress we made in 2018 is resulting in improvements in the availability, performance and reliability of our infrastructure backbone, driving better service delivery outcomes.

Accu-shoring has been instrumental in optimizing our talent base. At the end of Q4, approximately 51% of our employees were located in countries with lower cost labor markets, as compared to 45% in the past. Leveraging a more balanced global employee base will be a meaningful driver for continued margin expansion in 2019 and beyond.

Lastly, we continue to stand up a robust enterprise business intelligence program, leveraging best-in-class tools and technology. We have made significant progress, creating a data-centric culture at Conduent and this shift to becoming a smart company is a key dimension of our growth strategy.

The net impact of this transformation is expanded margins, reduced net leverage ratio, investments into the business to modernize our enterprise applications and technology stack, improve client experience and delivery quality and ultimately set the stage for our pivot to growth.

Our balance sheet is healthy and supports this growth agenda. We have paid down our high-cost debt, repriced our term loan multiple times and have an undrawn revolver to give us flexibility for investments or other uses of capital.

Moving to slide 5, let's go through our sales performance in the quarter. TCV signings grew by 7% in Q4 on a year-over-year basis and 26% in FY 2018 as compared to 2017. New business signings grew 6% in Q4 on a year-over-year basis. In Q4, our renewal rate was 93%, the sixth consecutive quarter that we've been above 90%. This is reflective of our strong client engagement, performance and the stickiness of our revenue stream. As it relates to new business in 2017-2018, we made investments in two key areas. First, the realignment and optimization of our sales force, which included bringing in new talent. And second, modernizing and building new technology capabilities. We are now realizing the benefit of these investments with Q4 new business signings of

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$621 million, more than 6% in the quarter as compared with Q4 2017. Several of our largest deals were platform or digitally enabled.

Our book-to-bill ratio was 1.2 times this past quarter and now has stayed above 1 for the fourth consecutive quarter. This is an important ratio as it is a leading indicator of revenue growth over time. We had a healthy pipeline of $12 billion in Q4, which was consistent with the prior quarters. The deals in the current pipeline are generally of higher value and play to our strength and our investments.

We remain focused on improving our capture and conversion rates, better client mining and service line penetration that will drive a better yield for us in 2019. Our sales force remains a key priority and we have embarked on a series of initiatives to reinvigorate our sales engine. These ranged from internal actions that reduced friction to doing business, increased training and development of our sales professionals and investments in tools and incentive programs to empower, equip and enable our sales force to drive sustainable, profitable top-line growth.

Before I hand the call over to Brian, I'll spend a few minutes discussing the progress made at our digital interaction and how we are transforming digital experiences for our clients. I will also delve a bit deeper into some of the key wins.

I am now on slide 6. To put our value proposition into context, let's consider the dynamics at play in our industry. As new and emerging technologies dramatically disrupt or upend our client's business models, the role of service partners such as Conduent and how we will provide value is fundamentally changing.

Historically, our clients have turned to BPO providers for a lower cost alternative that helps them achieve back-office efficiencies, primarily through labor or cost arbitrage. Even as technologies evolved, the value proposition for BPO was associated largely with cost and efficiency.

And while this remains an important benefit that we provide today, we operate in a world where the end-user experience has become increasingly critical to our clients' success. Conduent is integral to the mission-critical connections that our clients have with their end users on a daily basis. We sit at the intersection of billions and billions of transactions and power robust ecosystems and commerce, infrastructure, safety, healthcare, and government. For instance, we process approximately 757 billion of B2B payments annually.

We are the essential conduit to a two-way interchange. For example, more than 11 million employees globally are supported by our HRO services or one out of three of all U.S.-insured consumers are touched by our communications. We process approximately 43% of U.S. child support payments, 55% of SNAP payments and our presence accounts for nearly 45% of all U.S. tolling and parking transaction.

We have the ability to leverage the data and information that flows through our platforms to enhance the end-user experience and feed information back to our clients, corporations and governments to improve their offerings and/or business models, and we are achieving all of this through our aggressive investments in analytics and AI to improve this feedback loop.

We have moved from the back office to becoming the front office for our clients. Our platforms are scalable and API-extensible, allowing us to be the integrator of other third-party software and services, providing a comprehensive and integrated interactions ecosystem. We are transforming the way our clients operate. Building up the digital experience for the end users and allowing every interaction to be immediate, intelligent and individualized.

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Here are a few select examples that showcase the digital interaction evolution at Conduent. In Q4, we signed a new workers compensation contract with a large insurance carrier, the first client that will leverage Conduent for medical bill review, payments and utilization review on our new UR platform.

Our investments in this platform, bundled with our market-leading Strataware platform enables end-to-end automated matching of UR decisions with medical bills. This is a breakthrough in the workers compensation industry and is critical in addressing a key challenge for clients. Managing medical claim cost, while ensuring that an injured worker gets the right medical treatment.

The UR offering is an addition to our traditional workers compensation payment offering and is a big step to drive future growth in this growing and attractive market. At Gold Coast Health Plan, we are migrating Gold Coast Plan to our recently acquired Health Solutions Plus core administrative platform. The new technology suite, which was recently recognized as a leading solution in the space will drive end-to-end automation and analytics in Gold Coast Health Plan's administration. The result will be greater efficiency, lower cost and an improved member and provider experience, all the while maintaining compliance with regulatory requirements.

HSP is exactly the type of technology acquisition that we see adding immediate value to our core portfolio and to our clients. Our success in digital interactions is across commercial, government and transportation segments where we are bringing next-generation technology to large-scale public sector program. For example, in the fourth quarter, we won a large transportation contract to deploy our DriveSafe Enforcement System across traffic light intersections for a major California county, our first large-scale installation of this technology.

The DriveSafe System is deploying artificial intelligence to capture traffic violations. It will also provide smart city capabilities like automating the review process of violations using license plate recognition and violation validation. The system integrates with our Citeweb violation processing platform for public safety, leveraging the latest software, hardware and video analytics to provide a simple and seamless solution to help the county increase traffic safety and reduce accidents.

In closing, our progress to date as well as our portfolio of clients, assets, capability and people gives us the permission to play and, increasingly, the permission to win. I want to reiterate my confidence in the journey we are on to build a predictable, sustainable, market-leading enterprise. We made tremendous progress in 2018 on a number of fronts, aggressively reshaping our company around a core set of differentiated technology-based offerings and driving transformation across every facet of our business. The body of work that we have executed over the last two years was essential to give us a solid, clean foundation to now begin our pivot to growth.

With that, I'll turn the call to Brian to discuss our financial results and our guidance for 2019. Brian?

Brian Webb-Walsh

Chief Financial Officer & Corporate Vice President, Conduent, Inc.

Thank you, Ashok. As we have discussed throughout the year, our 2018 financials have several factors that impact year-over-year comparables. Throughout this presentation and in the exhibits in the appendix, we will provide both GAAP and adjusted numbers, which provided clean compare by removing the impact of the divestitures that we completed in 2017 and 2018, as well as the adoption of the 606 revenue recognition standard.

On a segment basis, we have moved the historical results for the 2017 and 2018 divestitures into the other segment. This includes the previously closed divested businesses, as well as the portfolio of select standalone

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customer care contracts, which we announced the closing of earlier this month. We have also made a change for our disclosure on the face of the P&L by removing depreciation and amortization from gross margin and moving up below the line. This is in an effort to align with how our peers report gross margin. In addition, we have made changes to the segment reporting, which I'll discuss in a few slides.

Now, let's start on slide 8 with an overview of the fourth quarter financial results. I won't go through the walk of the full P&L, but will instead focus on a few key line items. Revenue was approximately $1.3 billion for the quarter, down 3.7% after adjusting for divestitures in 606. Further adjusting for currency and strategic decisions, revenue was flat year-over-year. SG&A continue to improve year-over-year driven by our transformation initiative. When excluding the impact of 606 and divestitures, adjusted EBITDA in the quarter increased 0.6% year-over-year to $156 million with an adjusted EBITDA margin of 12.2%, a 60-basis point improvement. This was in line with the expectations given, stranded cost and increased IT spend, which we discussed in the last call.

We have increased our accrual for the Texas litigation to reflect the settlement agreement we announced yesterday. This issue is now fully resolved and behind us. Our transaction cost in loss and divestitures were $33 million primarily due to a non-cash impairment charge of $19 million associated with the sale of the portfolio of standalone customer care contracts.

Our pre-tax loss in the fourth quarter was $143 million, driven primarily by the Texas litigation settlement and divesture impacts. We had a GAAP net loss in the quarter of $140 million or $0.69 per share. Adjusted net income was $58 million and adjusted EPS was $0.26 per share driven by a lower interest expense and a lower effective tax rate.

Moving on to slide 9, I'll briefly highlight a few key points related to our full-year performance. Revenue of $5.4 billion was down 3.8% compared with 2017 excluding 606 and divestitures. Further adjusting for currency and strategic actions, revenue would have been flat. Compared with full-year 2017, excluding 606 and divestitures, adjusted EBITDA grew 7% and our adjusted net income was up 23.7% to $230 million.

Our full year adjusted tax rate ended up at 25.1% in line with our expectations. Adjusted EPS was $1.05 per share, an increase of 23.5% or $0.20 compared with full-year 2017. I'll note that we had several one-time items this year relating to litigation, restructuring, debt pay down and divestitures, all of which impacted GAAP results. We have provided the detailed reconciliations from GAAP to adjusted results in the appendix.

Before turning to the segment information, I'll note a few changes that we have made to our disclosure. First, we split our public sector business into the Government and Transportation segments. Government includes our state and local payments, government healthcare and federal offerings. Transportation includes our offerings focused on public safety, parking, tolling and transit. This aligns with how we now run the business and with our go-to-market strategy.

Second, we have pulled out our indirect IT and corporate costs from our segment reporting. These expenses include our shared IT infrastructure, enterprise applications, shared real estate and other corporate functions such as finance, HR and legal. Other IT and real estate costs that are directly utilized by the businesses will remain in the specific segments.

As we continue to focus on improved disclosure, we believe that breaking this out should provide a clean view of how the segments are performing. The majority of the stranded costs will come out of this corporate cost line. So given this new methodology reporting, segment adjusted EBITDA margins will not be meaningfully impacted by stranded cost takeout, but you'll see a benefit to the reported corporate results.

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As I go through the Commercial, Government and Transportation sector results for Q4 and 2018 full year, I will highlight the results adjusted for the impact of 606. The GAAP results are in the appendix. As a reminder, all of the divested businesses were moved into other and are out of the year-over-year compares.

Turning to slide 10, let's go through our segments. We have included a summary slide detailing the financial performance of all of the segments and have included the shared IT and infrastructure and corporate cost line. As reported, our Commercial business declined. But after adjusting for strategic decisions and currency, this segment would have been up 1.8% for the full year.

Our Government business declined by 4% for the full year, but would have declined 2.2% for the full year adjusting for the impact of strategic decisions. Our Transportation business grew 0.6% for the full year compared with 2017. However, adjusted for currency and excluding strategic decisions, revenue would have remained flat, 2018.

Looking at other, I'll remind you that revenue in the quarter within other was primarily from the stand-alone customer care contracts. Given the timing of the sale of these contracts, we'll still have some revenue from this divestiture in Q1. As I discussed, we have broken out our shared IT and infrastructure and corporate costs. In 2018, these costs were $647 million, 13% lower than the prior year. We have made meaningful progress on these costs throughout our transformation initiative, and we would expect to see continued progress as we address our stranded overhead costs in 2019.

Given the timing and final TSA, or Transition Services Agreement, linked for the standalone customer care divesture, we now expect to support the operations through the end of the year. In addition, some of the TSAs from the 2018 divestitures have been extended into 2019 for the terms of those agreements. As a result, stranded costs are now expected to be approximately $50 million in 2019.

We would still expect to take action on the stranded costs by the end of 2019. We will see the benefit of addressing the other $20 million of stranded costs throughout the year in our adjusted EBITDA growth rates and margins, but this benefit would be weighted towards Q2 through Q4.

Slide 11 provides an overview of our cash flow in Q4 and full-year 2018. Cash flow from operations was an inflow of $253 million in Q4 2018, primarily driven by working capital. We improved DSO two days in 2018, and we'll continue to focus on this important metric in 2019. Full-year CapEx was $224 million or 4.2% of revenue, an increase of $92 million compared with the last year, driven largely by our investments in IT.

Given our investments in both our IT infrastructure and client-facing platforms, we expect 2019 CapEx to be approximately 4.5% of revenue. Adjusted free cash flow was $218 million in 2018, above our most recent guidance range. Given the timing of CapEx and the typical seasonality of our business, we'd expect to see free cash flow weighted towards Q4 in 2019. We disbursed the final $77 million to employees as a result of the termination of our deferred compensation plan, so we will no longer have this impact in our cash flow from operations line moving forward.

Lastly, the settlement with Texas is structured for the payments to be made over three years. However, the agreement allows us to pay at any time. Given that these payments relate to a one-time occurrence, we will adjust the cash and tax impact and any related insurance recoveries out of our free cash flow calculation.

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Turning to slide 12, let's go through the updates on our capital structure. We ended the year with a healthy balance sheet. At the end of Q4 2018, our adjusted cash balance was $756 million, compared with $550 million of adjusted cash at the end of Q4 2017. Assuming only one rate hike in 2019 and no further changes to our debt, we expect our 2019 interest expense to be $90 million.

Our current net leverage ratio is 1.2 turns compared with 2.2 turns at the end of 2017. We paid approximately $90 million for the acquisition of HSP, which closed in early January. We have sufficient liquidity to make the Texas payments, and we will have a balanced capital allocation plan to drive shareholder value. As we look at potential acquisitions, we will remain disciplined on ensuring that they provide incremental capabilities and have financial performance that aligns with our long-term model.

Turning to slide 13, let's go through our 2019 guidance. We have provided a walk from our 2018 reported results to our adjusted 2018 baseline, adjusting for the impact of divestitures, including the stand-alone customer care contracts. We will also adjust our 2019 results to remove the one-month of revenue and EBITDA from this business. Making these adjustments allows for an apples-to-apples compare to our 2019 guidance.

We expect to report revenue of 0.5% to 1.5% growth in 2019, excluding any additional acquisitions, which is in line with our prior organic commentary. We will update guidance as we announce future acquisitions. We expect full-year adjusted EBITDA growth to be 10% to 14%, implying margins of between 12.5% to 13.1%. This EBITDA guidance reflects stranded costs of approximately $50 million in 2019 and also does not include any additional contribution from acquisitions.

Free cash flow conversion is still expected to be approximately 35% of our adjusted EBITDA, which reflects elevated CapEx for the year. I am pleased with the direction that the business is headed. Given our strong balance sheet, the completion of our divestitures and our investment in strategic, technology-focused offerings, I believe we are very well-positioned to pivot to growth.

We will now open up the lines for some questions. Operator?

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QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Today's first question comes from Puneet Jain of JPMorgan. Please go ahead.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Yeah. Hi. Thanks for taking my question and nice to see Texas settlement yesterday. Can you talk about your use of cash priorities for this year and beyond that? Obviously, there will be settlement payments. What should we expect for M&A contribution and cash outlay on M&A and capital returns for this year?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Sure. Good morning, Puneet. So, as we think about the cash usage, we currently have about $750 million cash balance. We used $90 million in January for our HSP acquisition. We do need some cash to deal with working capital fluctuations.

And I remind everyone, we do use cash in Q1 typically based on our seasonality. We tend to generate our cash in the fourth quarter and use a lot of cash in the first quarter. We also need cash obviously to support the Texas payments. And beyond that, we'll move forward with a balanced capital allocation strategy, which includes looking at all options to drive shareholder value, and that includes continuing to evaluate attractive M&A.

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah, let me just also add to that. I mean, clearly, as Brian mentioned, the conclusion of the Texas litigation does provide us with the visibility around cash requirements associated with that litigation. And now that we have visibility, we will continue to move forward with the balanced allocation capital strategy. As regards specifically on M&A, we've been looking at assets that provide platform or technology capabilities or have a foothold in our big bed areas like healthcare, government and transportation.

And as we look at these assets, and I've been saying this for a while, we find that the multiples of this is extremely high. So, we want to take a disciplined and thoughtful approach to ensure that just like we did the HSP acquisition, that this allocation, capital allocation creates immediate shareholder value. I'm also concerned with the fact that because of the specific quantum and timing for deals, we would not want to capture that upfront in our guidance and we will update you as we make these particular acquisitions.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Understood, understood. And it was nice to see increase in new business signings in Q4. But can that trend continue into this year? And is your backlog and pipeline are at a level that can support positive organic growth in 2019 or is there any like more signings or more incremental investments that's required to get to flat to positive organic growth?

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Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.
A

Yes. So, Puneet, you've seen our guidance points towards inorganic 1% growth. I think the investments that we have made in our sales force, in our hunters, client engagement is beginning to bear fruit. Obviously, this is – sales is a kind of a job where you're only as good as your last quarter. So, you have to continue to drive new business, which is a clear indicator of the fact that your value proposition is being accepted in the market. My pipeline is real. My pipeline is healthy. My conversion rates and yield have to improve. They have improved significantly over the last two years, but we have to sustain that momentum.

I don't have any one off-large deals in that pipeline, which I'm always concerned about. My tenure of deals are manageable in the two and a half to three and a half-year range. My book-to-bill is greater than one. So, if I look at the pipeline, the quality, the way the service line penetration is going, how the sales force team is gaining traction, the quality of my digital platforms that are finding traction in the market, I feel that we are in a place where we are ready for that pivot to growth.

Puneet Jain
Analyst, JPMorgan Securities LLC
Q

Understood. Thank you.

Operator: And our next question today comes from Shannon Cross of Cross Research. Please go ahead.

Shannon S. Cross
Analyst, Cross Research LLC
Q

Thank you very much. I was curious on the cost side with your transformation program running ahead of schedule. How are you thinking about opportunities going forward? Have you cut a lot of the low-hanging fruit or captured, I guess? Or is there a sort of multiyear path here? And then, I have a follow-up. Thank you.

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.
A

Yeah. Shannon, it's Brian. So, we do have a multiyear plan that we're working on for continued cost cutting. It's going to be focused on continued accu-shoring. We talked about getting our low-cost workforce to 55%. We ended the year in 2018 at 51%. So, we still have more opportunity there. We're going to be focused on automating client delivery and automating internal processes. So, a lot of that still ahead of us.

We're going to be focused on vendor spend reductions and continued real estate optimization and then, obviously, the stranded cost takeout that we've talked about. We're not going to quantify the value of that program. We're just going to continue to point margin improvement. And as Ashok mentioned, at our – the midpoint of our guidance, we're improving margin 1.3 points in 2019 and it will get us a three-point improvement since the time of spin when we execute against that.

Shannon S. Cross
Analyst, Cross Research LLC
Q

Okay. Thanks. And then, I noticed you mentioned insurance reimbursement in the commentary around Texas. I'm curious if we should think about that as being a potential and potentially meaningful and as well with regard to some of the vendor issues you had last quarter. Just curious how that's going in terms of reimbursement.

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Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.
A

Yeah. So, from an insurance perspective, for Texas, we have $100 million insurance policy and we're currently in litigation with carriers. We're aggressively pursuing insurance recovery. We can't really say more than that. And as always, with our vendors, we hold them accountable for any issues they create for our clients and we will continue to do that. Our first priority is always to fix and resolve the issues, but we also hold our vendors accountable.

Shannon S. Cross
Analyst, Cross Research LLC
Q

Okay. And just to clarify, the $100 million would be sort of – you would then net it against the $200 and some odd million that you're paying Texas?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.
A

I can't – yeah, I really can't say anymore. But it would be a recovery against what we're paying Texas.

Shannon S. Cross
Analyst, Cross Research LLC
Q

Okay. Great. Thank you.

Operator: And our next question today comes from Mayank Tandon of Needham & Company. Please go ahead.

Mayank Tandon
Analyst, Needham & Co. LLC
Q

Thank you. Good morning. Ashok, thanks for the color on the digital opportunities. I think I missed the number that you mentioned in terms of the signings that are now digital and if you could also just speak to the competition for these types of deals? Are they the same players that you were competing for on the traditional BPO or are these different players? And maybe if you could give us some sense of the win rates that are tracking currently versus say 6, 12 months ago?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.
A

Yeah. So, Mayank, good morning. The digital interactions is something that is evolving as our clients find themselves to be more and more in a place where their end users are consuming more technology and have a need for immediate intelligent in individual life services. So, given that we have – that we deliver our services and we have the advantage of delivering our services on technology platforms about 62% to 65% of our business is delivered on technology platforms, that allows us to bundle a variety of services from an end-to-end perspective and deliver to the client.

I don't think we necessarily have a lot of competition in this particular space. Obviously, it is evolving. A lot of people want to get into what I would say "digital". But clearly, the traction that we are building in the marketplace, the fact that we're able to bring bundled services, the fact that we are able to not only advice and consult on this, but also actually do the heavy lifting in terms of technology implementation, gives us a clear edge. And I think we're beginning to – the investments that we made in 2017 and 2018 and are continuing to make in our platforms, our client-facing platform, as well as the infrastructure on which it is built, we are finding that traction to only

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improve. We are finding the use of robotics, the use of – I mean, which is now literally table-stake. So everybody has to bring that to the table. Automation, robotics, the use of blockchain in many of our solutions, as well as a – the whole analytics space.

If you look at what we do, the name Conduent is a play on conduit, a pipe for an enterprise. So, we see a ton of transactions going back and forth and I gave some of the – some of those statistics in my prepared remarks. So, we see a ton of transactions going in back and forth. And we are sort of positioned right in the middle of government and enterprises on one side and their end-consumers on the other side.

So, we are able to give feedback to both side in terms of how the business and operating models of our clients need to change in order to cater to the increasing changing demands and requirements in which their – with their end-clients are consuming the services and goods that they have to offer.

So, I think we are – given our platform, given our depth, width and breadth of services, given our technology capability, we're fairly uniquely positioned in that. Yes, we see some of the traditional competitors are ramping up to this particular place. We're seeing new competitors come in as a result of it, but we're also seeing a lot of new ecosystem partners, technology partners, large- and small-based smart companies, very, very large companies willing to partner with us more aggressively to take some of these solutions to the market.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

That's very helpful. And as a quick follow-up, Ashok, you had shared some target stack at the Analyst Day last year in terms of getting to a mid-single-digit industry-type growth rate by 2020 and also mid-teens EBITDA margin profile. Given where you're at today, what's your confidence level in terms of getting to those targets by 2020?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

So, we're not going update our 2020 guidance today, but our long-term view remains that we can get there on the top line and we can get the margin profile of the company to 15%. We're making progress in 2019 towards that, but we're not going to update the 2020 outlook today.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

But that would include some M&A too, right, Brian? Just to confirm.

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yes, it would.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

Got it. Great. Good job, guys, and thank you very much.

Operator: And our next question today comes from Bryan Bergin of Cowen. Please go ahead.

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Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Hi, good morning. Thank you. I want to follow up on that margin question there. As we think about the margin expansion factors from here, can you comment on the contribution from cost takeout versus layering on the higher value services? I'm just trying to get a sense for or frame a reference to that 15% adjusted EBITDA target. And then as far as the stranded cost, can you just mention again the categories and how we should think about the cadence of those walking off in 2019 and then into 2020?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yeah. So, in terms of the margin improvement, a lot of it is going to be from cost cutting. But obviously, as we start to grow organically and add on M&A, that will provide EBITDA. And we're focused on doing deals that are higher than our margin target, both client deals and when we look at acquisitions, we have the same ones that we apply. So, they will help with the margins and a lot of those come from cost cutting and getting rid of the stranded overhead cost. At the midpoint of our guidance range this year, the margin will be 12.8%. That includes $50 million of stranded in the business still. Once that's removed, that's another point improvement, which gives us a 13.8%, so we start to get very close to that 15% just by executing against the stranded overhead cost.

Right now, we're currently under Transition Services Agreements. We're currently supporting four or five divestitures. The customer care divestiture will go through this year. The others will start to line down in the first half of this year. Once we do that, we can have some stranded overhead. So we'd expect to get about $30 million actually between now and the end of the first half and then the other $40 million at year-end and that's how we get to the $50 million impact this year versus $20 million of benefit that we'll see as we take those costs out. And when we think about the overhead, it's corporate overhead, it's the finance team, the accounting team, the HR team, the legal team, it's the IT infrastructure, which needs to get smaller because we're 20% smaller company and it's just focused on taking cost out in all those areas. And you can't do that until you're no longer supporting these divested businesses.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. That was very helpful. Thank you. And then, Ashok, as you think about the various service offerings that are now in your core, can you give us a sense of where you're most pleased with the turnaround in that performance? And then, alternatively, where you think you still have the most work to do?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. I think our Commercial business has really done very well. So if I look at their performance for the quarter and for the year, they've grown about 1.8%. I'm very pleased with the recovery on the Government sector side, which obviously we had talked about last time as some of the deals had slipped into Q4 as a result of the elections, et cetera. So they have recovered smartly.

I'm happy with the way my HRS business is gaining traction. That is a very big part of what I do in terms of services that we provide to our clients, employees, et cetera. That has really benefited from the refresh of technology that we have done. It's a huge investment that we have made, and we're beginning to see a lot of good traction in that space.

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Transportation is another space where we've shown good progress. Of course, I am concerned with the fact that the infrastructure issues that we have, which are most manifest in that particular area, are getting resolved. But there needs to be some work that we need to still do, and that's the investment that I talked about in my prepared remarks. But, overall, I think the core of the business is more stronger, more robust and pivoting to a place where we can now talk about more traction in the digital ecosystem.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Thank you.

Operator: And our next question, ladies and gentlemen, is from Frank Atkins of SunTrust. Please go ahead.

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thank you for taking my questions. Wanted to ask a little bit about currency. You've guided revenue in constant currency. Can you talk a little bit or just remind us your currency exposure on both the revenue and cost side?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yeah. So it's really from a revenue side that we talked about translation currency. And right now, based on where rates sit, it's about 40 basis points of a headwind. So it's not that big of an issue as we sit here today.

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. That's helpful. And then, as my follow-up, wanted to ask just maybe a two-part. Can you talk about any impact from the government shutdown? Has that impacted any of your verticals in 4Q or 1Q? And then, the margin of the work that you're seeing in the pipeline, if you could comment on that?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So, Frank, we have seen no impact as a result of the shutdown. The Government programs that we work on are fully funded. Obviously, if the shutdown had extended or there is another new version of it, I would not be able to comment on that. But the last one, definitely, all our programs are funded. Again, remember, we don't get paid on transaction basis; we get paid by account. So even if there is an impact or defunding of any of these agencies by the time it percolates to us, would be a significant lead time on that.

Do you want to take the next, Brian?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

What was your follow-up, Frank?

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Q

It was the margin of work that you're seeing in the pipeline.

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Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.
A

So that, again, the new deals that we're working, for the most part, all meet our margin targets. So the deals would be at 15% or higher, and that's how we manage the pipeline and manage the sales force.

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Okay, great. Thank you very much.

Operator: And our next question today comes from Keith Bachman of BMO. Please go ahead.

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)
Q

Hi. Thank you. I had two as well. First, I think, is for you, Brian. If you could just clarify when would you anticipate the first payment associated with litigation to be made? And my real question is underneath or above that is, what's your ability to do M&A this year? If I look at the cash flow effect of guidance you gave, just using round numbers, it would be about $200 million and if the Texas litigation is $80 million and you already did one deal in $90 million. So it doesn't leave a lot of free cash flow. So for M&A this year, given what you've already done in Q1, should we think about a more limited activities or would you take on debt to facilitate more M&A? And then I have a follow-up.

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.
A

So we have liquidity to deal with Texas and to do effective M&A. So it's not a barrier given our cash balance and then the revolver and where our leverage sits, but it's all about getting attractive M&A. And the first payment starts in Q1. The way the schedule works right now, there's three payments this year and $79 million gets paid based on way the payments are structured today. And the first payment happens in the first quarter of this year.

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)
Q

Okay. And then my – thanks for that, Brian – my follow-up is in the Transportation area. Ashok, you mentioned this a little bit in terms of still doing some investments there. What is your current win rates and how would you anticipate that evolving in Transpo, in particular? And just wondering when you could demonstrate some growth in that category?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.
A

Yeah. So Transportation is, as Brian was explaining during the segment explanation in his prepared remarks, consists of about four businesses. It consists of public safety, it consists of parking, tolling and transit. And in transit, we have two businesses: one is the U.S. transit business and the other is international transit. So we have actually seen good traction and growth in all these segments.

We've had issues with regards to our infrastructure, which we talked about last quarter with regard to a particular state in our U.S. tolling business. That is now behind us. Obviously, when you get negative publicity on that, it does have an impact with our other clients or prospects. We've had conversations with them.

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But fortunately for us, this issue is resolved. We have a clarification from the client as well that we are in operation. The backlog is done and the Toll-by-Plate is behind us. And that confirmation helps us go to our prospects and clients to continue to build traction and generate new business. So, overall, I would think it's a highly technology-intensive business.

Clearly, the impact of the legacy infrastructure and its non-performance has a direct and very quick impact on the tolling business. But the good news is that it's behind us. We still have some work to do to modernize it. But issues with regards to share infrastructure performance and availability, that's now behind us and I feel much more confident.

So Transportation is clearly a big bet for us. We think that it not only has opportunities in the public sector space, but combining that with our Commercial space and the fairly large European and American auto manufacturer footprint that we have, we think that we can expand this to beyond just a public sector opportunity to a much more of a combined public and private sector opportunity.

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)

Q

All right. Thank you.

Operator: And our next question today comes from Brian Essex with Morgan Stanley. Please go ahead.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Hi, good morning, and thank you for taking the question. Ashok, I just had a question, just a follow-up, I guess last quarter you noted lengthening sales cycles and another comment on that this quarter. Particularly with regard to the new business, TCV, how much of that was pushed from last quarter and if there's – is there maybe an offsetting amount pushed to next quarter? And maybe just a little bit of detail in terms of those sales cycles and how that issue is maturing as we head into 2019?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So, Brian, when you bring in a new value proposition especially in the digital space, there is a longer sales cycle than when you're just trying to sell a customer a service contract, which is basically takes a week to displace a competitor and take that job over. There's a lot more proving that you have to do, there's a lot more pilots that you have to do to convince the client, as well as ourselves that we can deliver. Obviously, as that traction builds up, as performance gets better and better, the infrastructure improves, word of mouth, people begin to believe that this is real, and that there's value to be obtained from it. So, that's basically what we are seeing. I wouldn't say that we are continuing to see dramatically increased sales lead time on most of the businesses that we're doing. Yeah, if you go in for a blockchain kind of opportunity, that takes a little more time in order to convince, explain and understand.

The one thing going from Q3 to Q4 clearly was from the Government business perspective. Remember, we have talked about in Q3 because of elections and so on support some of the transactions had not – they would not sign, so we saw some of that.

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But in the normal course of a 90-day period, you do have slips from one quarter to the other. I wouldn't read too much into it. We've had it in the past. We've had it – we'll continue to have that, but it's not significant enough for us to call that out.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's very helpful. Maybe if I could follow up. In terms of resolution to issues that you're having with the vendor that's not meeting their SLAs on the infrastructure side, maybe any way you can help us understand what you're doing to mitigate that issue. Is there any out to the contract and how we might think about your ability to engineer a solution around those issues, so that you can effectively deliver for your customers?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So, that's the focus area for us. The number one focus area is to remediate these contracts. The issues essentially relate to service and performance level. The backlog of work, speed and implementation, plan for modernization, and all of these are hampered because of the inflexible nature of the contract that were signed when this work was given. So, some of these were given as part of a wider program of giving the people, the assets and everything away.

Now, in terms of client-facing applications, we were able to take that back pretty quickly, right, in the beginning of 2017, you'd probably recall. But some of these ones, because of the inflexible nature of the contract and the way that it was designed, we've had to take them – we have had to take some time.

Now, clearly, our approach to them has been literally to hold them accountable. We have raised the bar on terms of the SLAs. We've brought in more experts because, remember, when this deal was contracted in 2015, our people, our assets, our infrastructure was all given away, so we were left with no capability.

So, we've hired new people. We've changed the leadership and management. We've brought in experts who can help us design this and we are looking at all opportunities in order to not only – my first focus is to ensure the availability and the delivery capability to my clients is done and that I hold these service providers accountable for the fixes and for the SLAs.

Operator: This concludes our question-answer-session. I'd like to turn the conference back over to Ashok Vemuri for any closing remarks.

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

Well, thank you, everybody, for joining us on this call. Clearly, as we said in our prepared remarks, we are happy that some of the legacy issues are behind us. We have spent the first two years cleaning up the shop as it were. We are now pivoting to growth. We think we have a sustainable, we think we have a robust business value proposition for our clients. Our digital story is resonating.

The team has significant confidence in its ability and I'm very thankful to my management for being able to conclude what I believe is the first phase of our transformation in the first two years. We are ready for our pivot to grow.

Thank you so very much.

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Operator: And thank you, sir. Today's conference has now concluded. We thank you all for attending today's presentation. You may now disconnect your lines and have a wonderful day.

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